Market Commentary

Leaving the question of price aside, the best business to own is one that over an extended period can employ large amounts of incremental capital at very high rates of return. –Warren Buffett

The recovery in the equity markets continued, with the S&P 500 returning 8.9% and the broader MSCI All-Country World Index returning 8.1%. Technology and other 'stay-at-home' stocks continued to do well and even hard hit industries such as hotels, restaurants, and retailers outperformed in September. Financial and energy stocks, however, continued to decline. While value outperformed last month, it lagged for the quarter and remains well behind growth year-to-date. Tech stocks peaked in early September then declined nearly 12% before recovering late in the month. **Higher quality stocks have generally underperformed with speculative growth stocks dominating market returns.** Most foreign markets continued to lag the US, with China's 14% year-to-date return a notable exception.

President Trump's COVID-19 diagnosis added yet another level of uncertainty to what could be a volatile period in the markets. As research on a viable vaccine progresses, expectations of its success and an end to the pandemic will likely begin to weigh on financial markets. In addition to a recovery of industries hit hard by the pandemic, improving vaccine prospects will likely put upward pressure on longer term interest rates. While the Fed controls short term rates, managing rates on longer term bonds requires more aggressive and less precise tools, such as quantitative easing, which involves the Fed using its balance sheet to purchase longer term bonds.

With yields on investment-grade bonds declining below current inflation rates, investors should examine how much safe liquidity they need. While markets will likely remain volatile due to uncertainty about the pandemic and the potential strength of the recovery, the Federal Reserve has made holding cash expensive. Recent guidance by the Fed indicates short-term interest rates will remain near zero through 2022, and there would be a tolerance for inflation levels above its target rate of 2%, as long as the long-term average remained within the target range. Holding safe liquidity equal to three to five years of planned distributions suffices for most situations. We will be providing ideas as to what to do with safe liquidity balances that exceed our recommended range to maintain. We have identified areas of the bond market with higher potential yields without significantly increasing credit risk exposure, as well as additional high quality stocks.

The economic recovery currently resembles a 'K', with the favored 'stay-at-home' sectors in technology and professional services thriving while industries that require personal contact like hotels, restaurants, salons, and other entertainment venues are languishing along with the energy and banking sectors. The impact of the downturn has fallen disproportionately on lower income workers, with employment levels at the top income quartile (annual incomes greater than $60K) down around 1% compared to a 14% decline for the bottom quartile (annual income below $27K). Extended unemployment benefits have cushioned the blow, but it remains uncertain when jobs will come back in the service industries that support these workers.

Similarly, small businesses – generally defined by the US Small Business Administration as privately held firms with less than 500 employees – have suffered more than publicly traded companies. The importance of these small, privately held businesses stems from the fact that there are over 30 million of these companies and they employ nearly half of the US workforce. Firms in the Russell 1000 Large Cap Index and Russell 2000 Small Cap Index experienced an average revenue decline of around 15%, while small business revenues fell by nearly 50% initially and remain 22% below pre-pandemic levels. Publicly traded companies avoided this decline largely because the most-impacted personal service industries comprise a smaller portion of the universe (there are no publicly traded nail salons, for example). Additionally, both the large and small cap universe contain a population of high quality businesses with consistent revenue streams – anything from software companies to utilities – that experienced little direct economic impact from pandemic so far.

Speculative growth stocks drove market performance so far this year. The strong gains from stalwarts like Microsoft, Apple, Facebook and other large tech companies were eclipsed by performance of less mature tech stocks such as Zoom or DocuSign, not to mention Tesla's over 400% gain. This performance coincided with the emergence of a new day-trading culture reminiscent of the late 1990s. Centered on social media and new trading platforms such as Robin Hood, a generation too young to remember the dot.com bubble appears eager to repeat the same mistakes. The valuations of some of these stocks rival the peak of the late 1990s. While many high flyers of the period went on to become successful, the extreme valuations handicapped returns from these companies for nearly a decade. For Example, Amazon.com's performance from its peak in the late 1990s only caught up to the S&P 500 after the 2008 Financial Crisis. Our growth managers focus on profitable, high quality businesses, able to deliver sustained growth for longer periods with less potential downside. As the Warren Buffett quote at the beginning indicates, the best long term investments are companies that can reinvest profits at high rates of return. They may lag during periods driven by speculation, but offer the potential for better long term performance.

Meanwhile, **value stocks showed some signs of life**, outperforming growth in the month of September. A close look at value indexes reveals, not surprisingly, a disproportionate weight in industries hardest hit by the pandemic, including energy, banks, aerospace, hospitality, and real estate. At quarter end, over 40% of the Russell 1000 Value Index was allocated to industries with negative year-to-date returns, compared to approximately 11% for the growth index. Accordingly, potential outperformance of value stocks is closely tied to expectations of a recovery of industries impacted most severely from the pandemic. Markets generally lead events in the real economy, so value stocks will likely rally on early indications of the pandemic's end.

In comparison to the US market, European stocks appear cheap. The P/E ratio for the MSCI Europe Index currently trades at over a 20% discount to the S&P 500. However, this discount narrows once differences in industry weighting are accounted for. Pharmaceuticals, food companies, financials and luxury goods companies dominate European equity markets. Europe lacks the software and Internet platform companies that comprise the largest weights in the S&P 500. The S&P 500 traded at a forward P/E of 22.8 on August 31 compared to 17.4 for the MSCI Europe. However, if European industry weights are applied to the S&P 500, the discount narrows. An index comprised of S&P 500 stocks weighted with European industry weights had a P/E of 19.2, so approximately 2/3rds of the discount of European stocks relative to the US can be accounted by differences in industry composition. This analysis does reveal a material, albeit smaller, discount for European stocks relative to the US, and the continent contains good investment opportunities. Our client portfolios remain underweight relative to global indexes and we continue to review weightings to achieve appropriate risk/reward objectives.

Entering what hopefully becomes the endgame of the pandemic requires investors to maintain discipline. Markets exhibited extreme volatility adjusting to the onset of COVID-19 and the accompanying fiscal and monetary policy responses. Markets may exhibit similar (but hopefully lower) volatility adjusting to the post-pandemic world. Dramatic reversals may occur, with sharp rallies from hard-hit sectors like energy or retailers, which may obscure the long term challenges faced by these industries. We reviewed performance and positioning with our managers over the last several weeks and none expect a fast return to economic life as it existed in 2019. After the 2008 Global Financial Crisis, central banks engineered policies to drive yields on safe investments below the rate of inflation. However, depressed prices on risky assets at that time offered outsized returns. **The potential return environment today appears modest by comparison and therefore we continue to advise our clients on the need to be careful chasing short-term movements or speculative trends.**

- Stephen C. Browne, CFA
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